THE WESTERN POWER CRISIS

In 2000 and 2001, electric utilities in the Western United States, including the Department, were subject to a number of unprecedented developments that had severe negative effects on their financial results. Key factors in the events of the past two years were: (i) restructuring of the electric utility industry in the State of California, (ii) price volatility in wholesale markets for electricity and natural gas, and (iii) water conditions in the 2000-01 water year that were among the lowest ever recorded in the Northwest region.

Utility Industry Restructuring in California

As required under a 1996 law, the State of California restructured its electric utility industry in ways which were expected to improve the efficiency of the wholesale electricity market in California. These expectations were not realized. Growth in demand outstripped available supply, which was depressed by an unusually high level of plant outages in the spring of 2000. Defects in the design of California's deregulation efforts created the potential for manipulation of market prices by entities with market power. Power emergencies and rolling blackouts occurred frequently during the period from May 2000 through April 2001. With rates frozen, investor-owned utilities were unable to recover their costs and experienced severe cash flow pressures.

Price Volatility in Wholesale Energy Markets

From May 2000 to April 2001, prices in California wholesale markets increased to unprecedented levels. The sharp rise in wholesale prices spread from California throughout the western region. Increases in the price of natural gas, the major fuel for thermal generation of electricity in the western region, exacerbated the pressures on price emanating from the California market. Wholesale market prices, as measured by the Dow-Jones Mid-Columbia Index for peak period transactions, rose by a factor of ten, from an average of $27 per MWh in the first quarter of 2000 to $272 per MWh in the first quarter of 2001. FERC initially declined to intervene in the western power market to control prices, but with major power shortages and continued high prices predicted for the summer of 2001, FERC instituted a price mitigation and monitoring plan on June 19, 2001, that set upper limits on prices in the western region. By that time reductions in the demand for power and the appearance of new power supplies in the market had already caused prices to decline from their peak levels. Prices continued to fall through the remainder of 2001 and into the first quarter of 2002. From January through May 2002, spot market prices were at levels more consistent with experience prior to 2000. In June and July improved water conditions together with a delayed spring runoff resulted in an increase in the amount of surplus energy available in the Northwest. As a result, spot prices fell to the $9-10 per MWh range in June and July. Prices returned to more normal levels in August and September.

Adverse Water Conditions in the Northwest

Water conditions in the hydroelectric operating year beginning October 1, 2000, were among the lowest ever recorded in the Pacific Northwest, which relies on hydroelectric generation for about 70 percent of its power resources. Under normal water conditions, the Department's hydroelectric resources generate 813 average MW of power. In calendar year 2001, the Department's hydroelectric output was 450 average MW, or 55 percent of normal. Having just completed its rate case in May 2000 with a Record of Decision ("ROD") that provided for moderate increases in rates for the next five years, Bonneville was forced to announce that it would have to raise its rates sharply in response to the low water conditions and high market prices.

The Effect on the Department

The Department's reliance on the wholesale power market was greater than normal in 2000 and the first nine months of 2001 because of decisions made by the Department in 1996 to limit its purchases of power from Bonneville through October 31, 2001, and in 2000 to sell its eight percent share of the Centralia Steam Plant. Each of these decisions had the effect of requiring the Department to purchase more energy in the wholesale market to meet load. The amount of the purchase requirement increased as water conditions worsened in the water year beginning October 1, 2000. The combination of high market prices and poor water conditions had a severe impact on the Department's financial status in 2000 and 2001. In 2000 and 2001, the Department incurred net costs of $558.4 million for its wholesale market purchases and sales, an amount which exceeded estimates made in 1999 for rate-setting purposes by $538.8 million.